RECENT MAJOR COLLECTIVE BARGAINING AGREEMENTS

Major settlements in the past two years have often broken from the pattern of the last two decades by calling for no general wage increases or in some cases for actual givebacks. It is still too soon to know whether the pattern will be reestablished with economic recovery and more competitive exchange rates, or whether the changes will be permanent. Some major settlements:

Autos. No general wage increases, and reduced cost-of-living adjustments (COLAs). In exchange, job security improved. Chrysler workers got back some of their earlier wage cuts, but failed in 1983 to negotiate further catch-up with the rest of the industry.

Rubber. No general wage increases, but COLAs retained and pension and insurance benefits improved.

Trucking. No general wage increases, though economic provisions can be renegotiated early if financial conditions improve. Semiannual COLAs changed to annual, and part of the COLA can be diverted to maintaining current pension, welfare, and health benefits.

Meatpacking. A 3-year agreement gave back the wage increases in the old contract; COLA was suspended. In exchange, greater job security.

Electrical workers. This industry is in relatively good health: general wage increases continue, with improved COLAs and lay-off benefits.

Steel. A 41-month contract from March 1983 in effect before old contract expired. Base pay cut, to be restored in February 1986. COLAs suspended for five quarters, then reduced. Employee unemployment benefit contributions increased drastically, benefits for early retirement increased. Cost savings to be spent in the steel industry.

Aluminum. No general wage increase, COLA reduced slightly.

Farm Equipment. For most of the industry, there was no general wage increase but the COLA was maintained and a new profit sharing plan introduced. The settlement at International Harvester suspended the COLA for fifteen months.

adjustment in the first quarter was -1.4 percent for the first year of the contract, the first negative average in the 15 years the data have been collected. Wage adjustments were to be 2.7 percent over the lives of contracts settled in the first half of the year, compared with 6.7 percent the last time the same contracts were renegotiated (two or three years ago). These calculations do not reflect scheduled cost-of-living adjustments, but because of the reduction in inflation these too are likely to be smaller than in the past.

Major collective bargaining agreements cover less than 10 percent of all workers in the United States. But wage growth has slowed dramatically throughout the labor market. The employment cost index for compensation (including fringe benefits) of nonunion workers increased 6 percent from the first quarter of 1982 to the first quarter of 1983, down from 7 percent the previous year and 10 percent the year before that. The index for wages and salaries of nonunion workers slowed even more from 1982 to 1983, down from 7.5 percent to 5 percent. Average hourly earnings growth for all workers, including both union and nonunion workers, appears to have been running at about a 3 percent rate in the past six months, including the effect of some major wage cuts such as that in the steel industry.

Most analysts expect wage growth to accelerate, though not by very much. As production, employment, and corporate profits rise, there will be less pressure on wage bargainers to accept the freezes and givebacks that have dominated the recent picture. In addition, wages in some industries will accelerate as delayed cost-of-living adjustments come into effect—though their impact will be diminished by the very low recent increases in the CPI. Increases in employer contributions to Social Security will add about 0.3 percent to employee compensation in each of the next two years; wage growth may be held back a little by this, but by most estimates the effect should be very small.

Interest Rates

After declining sharply a year ago, short-term interest rates stayed close to 8 percent from September 1982 to May of this year, despite very low levels of economic activity and rapid growth in the money supply. By early August, however, the three-month Treasury bill rate had risen to about 9.5 percent. The long-term AAA corporate bond rate dropped from 15 percent in June 1982 to 12 percent in October, and remained within half a point of that level through May 1983, but has risen by about 1.4 percentage points since mid-May. The widely watched prime rate fell from 16.5 percent to 13.5 percent between June and September 1982, and then gradually eased down to $10\frac{1}{2}$ percent, which it reached in March. It increased to 11 percent in early August. The effective interest rate on conventional mortgages dropped more slowly last fall than other rates, but continued to decline until recently and in early July was down to 12.6 percent (from 17 percent a year earlier). 5/ Secondary market rates for mortgages have since risen to about 13½ percent, and the FHA mortgage rate has also been raised from 12 percent to 13.5 percent.

While nominal rates have fallen from their early 1982 highs, reducing the costs of borrowing, real interest rates are still at almost unprecedented levels. It is difficult to measure the inflation premium that these rates embody, but if the CBO forecast of about 5 percent inflation is close to the expectations of market participants then the real rate on Treasury bills is about 4 percent and that on long-term bonds is 6 to 7 percent. Federal Reserve Chairman Volcker has estimated that many people expect inflation to rise to 7 percent in the long run. 6/ Even if this is correct, the implied real rate on long-term bonds is still about 4 to 5 percent. Real short-term rates are higher than at any time since the Depression.

The reduction in interest rates since last summer has also contributed to a large increase in household wealth. Lower interest rates increased bond prices directly, but also were a major factor in the rally in stock prices:

- The stock market probably anticipated improved sales of durable goods and other interest-sensitive items. In fact, as noted above, durable goods sales grew rapidly in the first half of 1983, producing a turnaround in corporate profits, especially of the auto companies.

- Lower real interest rates also raised the market's valuation of expected corporate earnings (because they would be discounted less).

- Lower nominal interest rates reduced the debt service of corporations, which have become increasingly leveraged in the postwar period and have recently financed much of their debt in the short end of the market. Thus, expected earnings and cash flow were improved.

5/ Rates reported by Federal Home Loan Bank Board.

6/ Before the Subcommittee on Economic Policy, Senate Banking Committee, July 28, 1983.

As a result, stock prices have risen 53 percent over the last twelve months. A later section will show that the increase in household wealth puts consumers in an excellent position to expand spending again, and may help explain the current low saving rate.

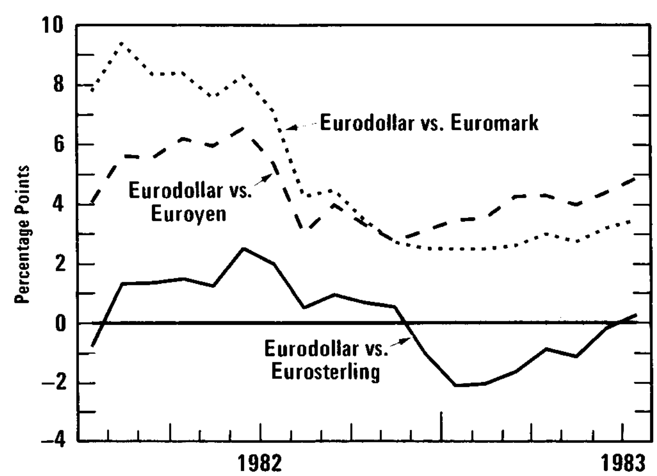
Dollar Exchange Rate

In the first half of 1983, the dollar climbed to record levels against the currencies of its major trading partners. By July, the trade-weighted value of the dollar stood nearly 50 percent above its July 1980 level. As a result the U.S. balance on current account dropped from a $4.5 billion surplus in 1981 to a $11.2 billion deficit in 1982, and in the first quarter of 1983 the deficit was $12.2 billion at an annual rate. The dollar maintained its strength in the face of these adverse trade flows because of a heavy influx of capital from abroad, drawn by high U.S. interest rates.

Nominal interest rates remained high in the United States even though inflation had slowed. Equally important, investors did not expect further reductions in U.S. interest rates. Given the desire of foreign central banks to lower their own interest rates, the interest rate differential did not seem likely to move against the United States in the foreseeable future. As shown in Figure 8, U.S. interest rates actually rose relative to foreign rates in the second quarter of 1983.

As the dollar continued to strengthen throughout July and into August, foreign governments and U.S. exporters renewed their calls for policies to stem the dollar's rise. These pressures, combined with a belief that foreign exchange markets were becoming disorderly, induced the U.S. government

Figure 8.
Eurodollar Interest Differentials



SOURCE: Reuters.

NOTE: Differentials are based on three-month Eurocurrency deposit rates.

to join its trading partners and intervene in currency markets in an attempt to moderate the dollar's rise.

The strong dollar has had mixed effects on the U.S. economy: it has severely damaged the competitiveness of U.S. industry in the world market, but has contributed to the slowing of inflation and wage growth in this country. In the rest of the world, the strength of the dollar has heightened the debt crisis in developing countries by increasing the cost of their debt repayments, and the price of oil, which is denominated in dollars, but it has also improved the competitiveness of their goods in the U.S. market.

The future course of the dollar will depend importantly on the monetary policies pursued by the Federal Reserve and other central banks. Central bank behavior must be gauged in the context of the current economic environment. It is now evident that economic recovery among U.S. trading partners will lag the U.S. recovery and may not be as strong. Unemployment rates have risen in these countries and inflation has fallen (Table 9). Thus foreign central banks are probably even more concerned than the Federal Reserve to lower their interest rates. If U.S. interest rates fall, the trading partners will seize the opportunity to push their own rates lower. If U.S. rates rise, it is unlikely that the trading partners will allow their interest rates to keep pace. Instead, foreign central banks may choose to accept the stimulative and inflationary effects of further depreciation rather than allowing significantly higher interest rates to undermine their economic recoveries. In the short term, therefore, it is unlikely that the interest rate differential will move against the United States, and the dollar is expected to remain strong.

Moreover, the United States remains a "safe haven" for investors in the general atmosphere of uncertainty created by the debt problems of developing nations—problems that have been exacerbated by the high interest rates.

Looking beyond 1983, the overvaluation of the dollar and the relatively rapid U.S. economic recovery point toward a continuing deterioration of the trade account and increasing downward pressure on the dollar. If U.S. interest rates decline sufficiently in 1984 to permit a narrowing of the interest differential, the trade sector will begin to assume its normal role in determining the value of the dollar.

SOURCES OF PROSPECTIVE GROWTH IN DEMAND

The recovery so far has been characterized by a sharp slowing in the rate of inventory reduction, strong growth in consumer spending, and a

TABLE 9. INFLATION AND UNEMPLOYMENT RATES IN THE UNITED STATES AND SEVEN OTHER MAJOR INDUSTRIAL COUNTRIES THROUGH THE FIRST QUARTER OF 1983

	United States		France		West Germany		Italy		Netherlands		United Kingdom		Japan		Canada	
	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U
1978	7.7	6.1	9.0	5.3	2.8	4.3	12.1	3.7	4.1	4.1	8.3	5.5	3.8	2.2	8.9	8.4
1979	11.3	5.8	10.8	6.2	4.1	3.8	14.7	3.9	4.2	4.1	13.4	5.1	3.6	2.1	9.1	7.5
1980	13.5	7.1	13.5	6.7	5.5	3.8	21.2	3.9	6.5	4.8	18.0	6.4	8.0	2.0	10.2	7.5
1981	10.4	7.6	13.1	7.8	5.9	5.5	19.5	4.2	6.7	7.4	11.9	10.0	4.9	2.2	12.5	7.6
1982	6.1	9.7	11.9	8.4	5.3	7.5	16.3	4.8	5.9	10.1	8.6	11.7	2.7	2.4	10.8	11.0
1983:1	-0.27	10.3	11.1	8.8	2.0	8.9	14.7	5.2	.30	14.4	2.0	12.6	-1.3	2.7	2.4	12.5

$\dot{P}$ = Percentage change in consumer prices from preceding year (1983:1 calculated as percentage change from 1982:4, then annualized).

U = Rate of unemployment (as percent of civilian labor force).

SOURCE: U.S. Department of Commerce, International Economic Indicators (June 1983), pp. 43, 63.

recovery in housing. The equipment component of business fixed investment is also showing some early signs of improvement. But net exports are getting rapidly worse. With consumption growth running ahead of the growth in other demand categories, household income has lagged and the saving rate has fallen from over 5 percent in 1982 to 3.9 percent in the second quarter of 1983. This is the lowest saving rate in the past 30 years. Consumption growth clearly cannot be sustained at recent rates unless disposable personal income picks up.

In fact, near-term acceleration in disposable income seems very likely. The tax cut in the third quarter of 1983 will add about $30 billion to disposable income at an annual rate. There will be gains in spending throughout most of the economy, generating increases in personal income. The weakest outlook is in net exports, where the high exchange rate and poor growth among U.S. trading partners promise an even worse performance this year than last (see Figure 9).

This section examines recent developments in the major sectors of demand, pointing out their potential strengths and weaknesses in the months to come. A common thread in the analysis is the sensitivity of the recovery to interest rate changes: rising interest rates could choke off demand for housing and durable goods, increase even more the number of business failures, hold back investment growth, and worsen net exports.

The Consumer

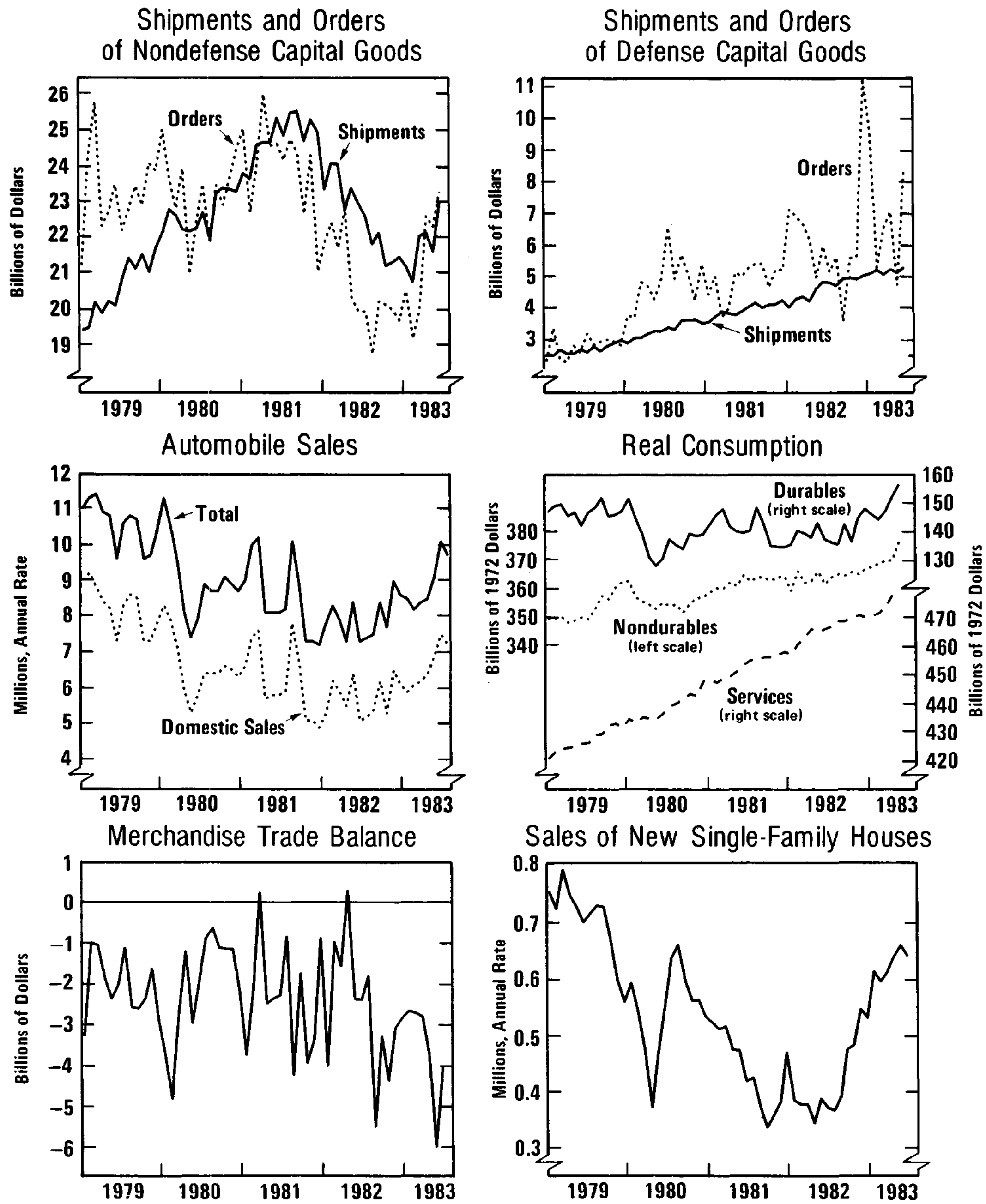
Consumption has grown rapidly in recent months, accounting for about three-quarters of real GNP growth in the first half of 1983. Most determinants of consumer spending point to further rapid increases:

- Tax cuts have given a substantial boost to disposable income in the last two years;
- Consumer confidence is high;
- Household wealth has increased substantially;
- Unemployment is falling and employment is growing; and
- The housing recovery has generated increased demand for durable appliances and furniture.

Consumption rose faster than income in the second quarter, pushing the reported saving rate down to 3.9 percent from 5.4 percent in the first

Figure 9.

Sources of Demand: Recent Movements (Monthly)



SOURCE: U.S. Department of Commerce.

quarter. 7/ It seems unlikely that such low saving rates will be maintained, and further consumption growth will therefore require even more rapid growth in income.

Disposable Income. Real disposable income grew through the past recession, buoyed by tax reductions, low commodity prices, and high interest income. The growth occurred in spite of the sharp slowing of wage growth and rising unemployment, which tend to dampen income growth.

In the current recovery, however, disposable personal income has grown rather more slowly than in previous recoveries. Lower interest rates caused personal interest income to fall in the first two quarters of 1983. Government transfers to persons have also grown less than in typical recoveries, because of the rapid decline in unemployment and the increasing numbers of the unemployed who have exhausted their benefits. Other components of disposable income grew at about the same rate as in past cyclical upturns.

Tax changes point to a sharp increase in disposable income in the third quarter of 1983. The final installment of the 23 percent tax cut put in place by the Economic Recovery Tax Act of 1981 reduced tax withholding by about $30 billion in July, providing a temporary boost in the growth of consumption and saving in the third quarter. Looking further ahead, the Social Security tax increase at the beginning of 1984 will have no immediate effect on disposable personal income, since it is to be offset by a tax credit. (The employers' portion will not have a similar offset).

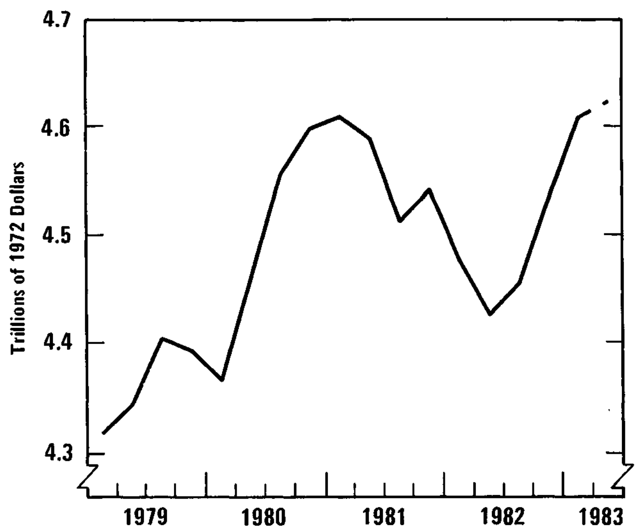
Household Wealth. Although consumer disposable income remained quite strong through the recession, household wealth deteriorated sharply until the middle of 1982. House prices ceased to grow as they had in the 1970s, and rising interest rates contributed to falling stock market values. Real household net worth fell by about 2.8 percent from 1979 through mid-1982.

Since the middle of last year, the financial situation of consumers has improved substantially:

7/ The swing in the saving rate was exaggerated by the weather. Warm winter weather reduced spending on heating in the first quarter, while the cool, wet spring meant more heating than usual in the second quarter. The heat wave in July and August seems likely to push up cooling demand in the third quarter.

23-750 O - 83 - 4

Figure 10.
Household Net Worth



SOURCES:
Federal Reserve Board; Congressional Budget Office.

NOTE:
Projection for 83:2 based on increase in stock market prices.

- o The stock market boomed, in response to lower interest rates and the improved financial condition of corporations;

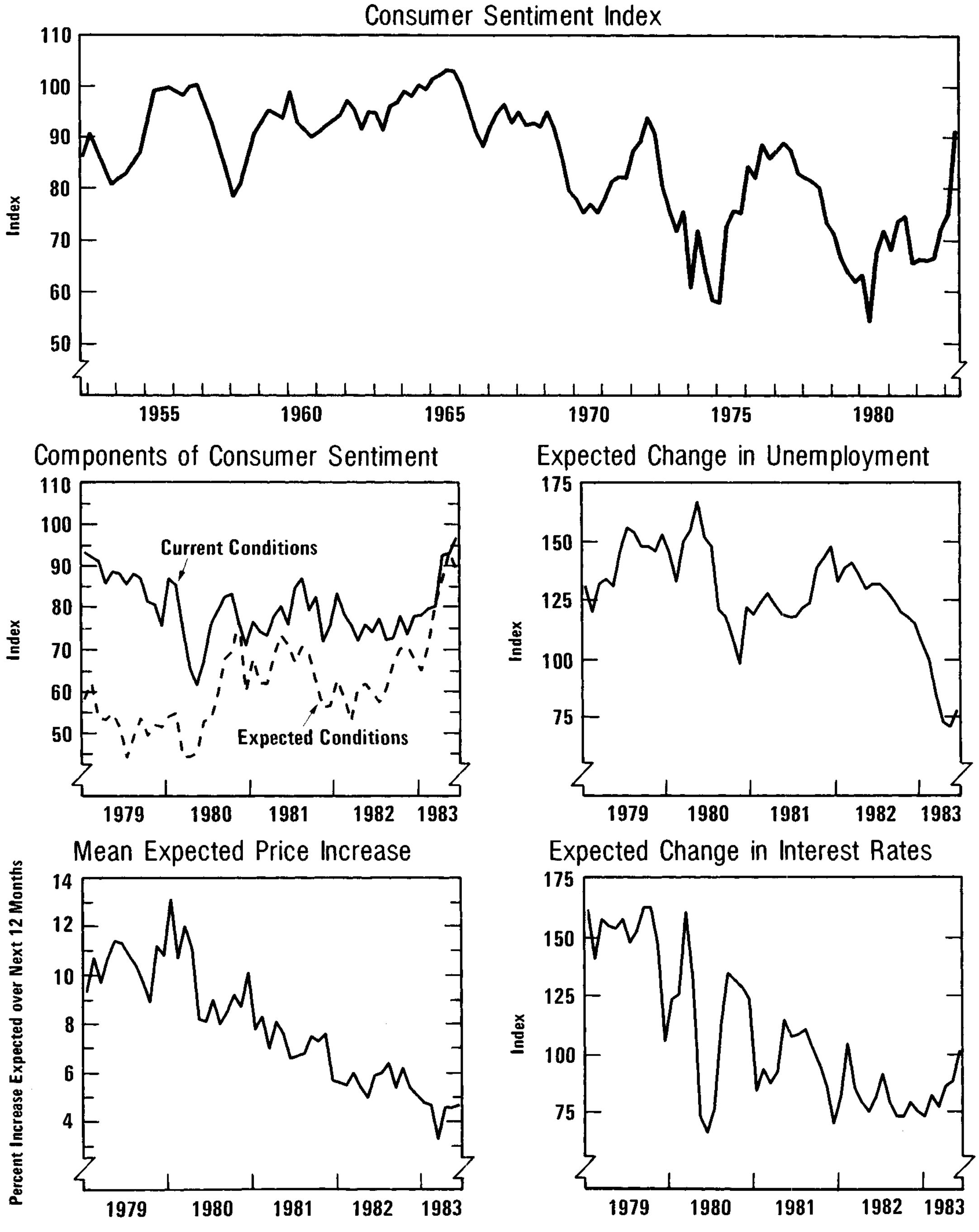
- o Interest rates fell, raising bond prices and the value of the household holdings of bonds; and

- o House prices began to rise again, as mortgage rates fell and the housing market improved.

As a result of these developments, household net worth increased by about 7.2 percent between the first quarters of 1982 and 1983, despite low personal savings (see Figure 10).

Consumer Confidence. Consumer confidence, too, sustained a remarkable rally in early 1983. The confidence measures of the Conference Board and the Michigan Survey Research Center are up by 67 percent and 52 percent from the levels of the third quarter of 1982 (Figure 11). The most rapid improvement has been since February. The rise in consumer confidence extends over almost all components of the Michigan index, suggesting fewer worries about unemployment and inflation, more awareness of lower interest rates, and the expectation of a resumption of economic growth. However, some analysts fear that the improvement in consumer confidence depends too much on the decline in interest rates from last year's levels, and that increases in interest rates, even modest ones, could quickly reduce

Figure 11.
Sources of Consumer Confidence



SOURCES: Survey Research Center, University of Michigan; Congressional Budget Office.

NOTE: Expected conditions are personal and business conditions one and five years ahead. Expected changes in unemployment, prices, and interest rates are for the next year.

confidence. Fewer consumers report that they expect further reductions in interest rates, so some of the recent strength in durables and housing could reflect advance purchases in anticipation of interest rate increases.

Saving

Why has consumption apparently run ahead of income, pushing the saving rate to unusually low levels?

- o Preliminary data for the second quarter may understate actual income. A similar episode three years ago caused some concern about a low saving rate: but revisions in the data showed that saving had not in fact been particularly low.

- o National income accounts income data do not reflect the recent capital gains in the stock market. These wealth increases may support higher consumption levels, and thus push down the saving rate.

- o Capital gains in housing may also be supporting higher consumption. In the first quarter of 1983, the latest period for which information is available, homeowners as a group realized about $60 billion of equity in their existing homes by taking out mortgages. This was up from $30 billion in most of 1982. If the same phenomenon occurred in the second quarter of 1983, then the consumption growth may have been supported by the capital gains in housing that were made in the late 1970s, but which are only now being realized.

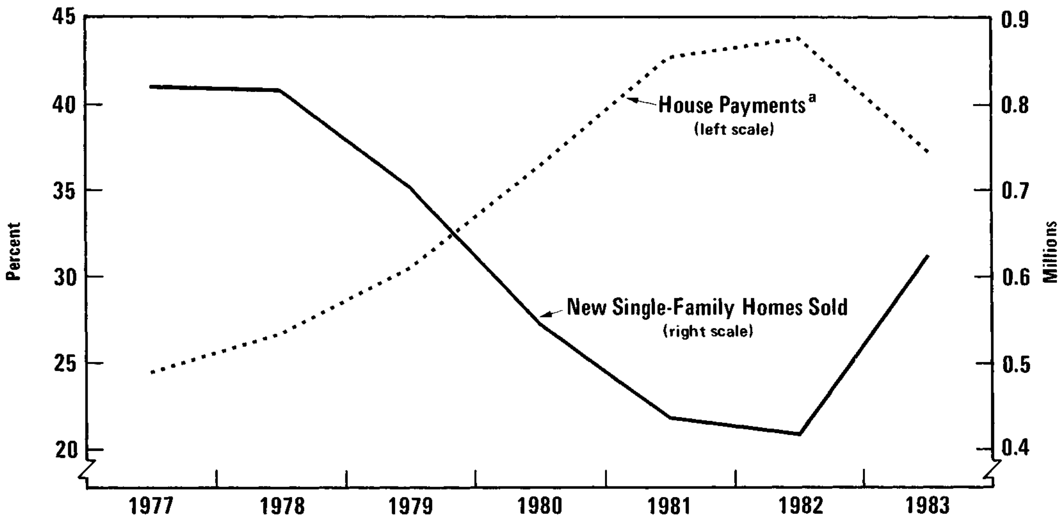
- o Consumers may have simply anticipated the July 1983 tax cut. The reduction in the saving rate is worth abut $35 billion at an annual rate, close to the reduction in withholding in July.

Housing

The housing industry showed perhaps the most dramatic early evidence of renewed strength in the economy. It had been depressed since 1979, when a combination of rising house prices and almost unprecedentedly high interest rates pushed new home purchase costs out of reach of many families.

The mortgage rate has now declined to about 12.6 percent from a high of 16.3 percent in November 1981, and house prices have not risen by very

Figure 12.
House Payments and Houses Sold



SOURCES: U.S. Department of Commerce, Bureaus of the Census and of Economic Analysis; Congressional Budget Office.

NOTE: 1983 values are for first half of the year.

[a]House payments, based on current mortgage rates and average price of houses sold, as percent of median family income.

much since 1979. 8/ Partly as a result, starts of new homes have increased from an annual rate of 1.0 million units last year to 1.7 million in June of this year. The number of new single-family houses sold has nearly doubled since mid-1982 (see Figure 12).

Household formation and the shortfall in additions to the housing stock in the past few years have created a backlog in demand for housing units. But other factors may prevent a return to the boom years of 1977-1978, when housing starts were around 2 million units:

- Mortgage interest rates have risen from about 9 percent in 1977-1978 to a current level of about 12.6 percent. While the current rate is considerably below rates that were prevalent in 1980-1981,

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8/ Mortgage rates quoted are the effective rates on mortgage loans closed, as given by the Federal Home Loan Bank Board. Other frequently quoted rates, such as that for mortgage commitments or the secondary market rate for FHA mortgages, are often much higher.

it still implies mortgage payments about 30 percent higher than in 1978 for a mortgage of the same size.

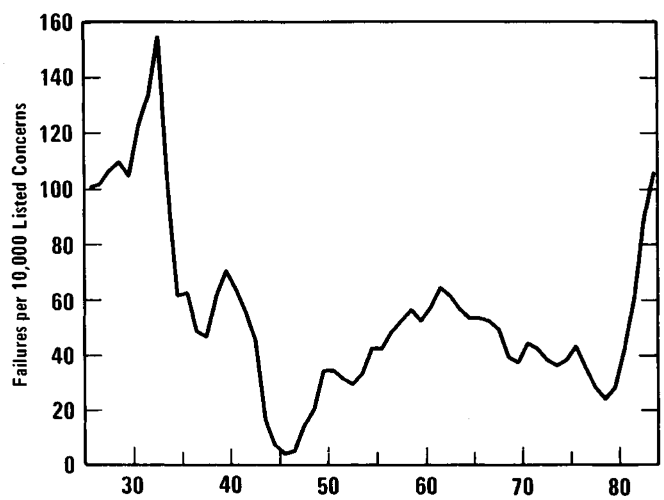
- House prices in 1977-1978 were rising fast, and were widely expected to continue rising. Thus the real rate of interest on mortgages was much lower than the nominal rate, and was probably negative. Few people now expect a resumption of rapid increases in house prices.

Because of these two major changes, housebuilding may not consistently reach or exceed the levels of 1978-1979. Recent increases in mortgage rates suggest that further increases in homebuilding may be small.

Businesses

Business failures are at postwar record levels (see Figure 13). The high rate of failures is the result not only of the most severe postwar recession, but also of exceptionally high real interest rates. Businesses responded to high long-term interest rates and a depressed stock market by reducing the share of capital financed by long-term debt and by equity. This avoided locking in high capital costs for the long run, and has enabled corporations to take advantage of falling short-term interest rates and a rising stock market over the past year. But it has left them vulnerable to increases in interest rates, which could quickly increase their debt-service costs.

Figure 13.
Business Failure Rate



SOURCE: Dun and Bradstreet.
NOTE: 1983 data are for the first half of the year.

Corporate profits (after adjustment for the effects of tax law on depreciation allowances) rose 12 percent in the first quarter of 1983, and probably have increased sharply again in the second quarter. The profit increases stem from cyclical improvements in productivity, from the deceleration of wages--which has been much larger than in previous recessions--and from lower interest costs. First-quarter profits of oil refiners were also pushed up by the decline in crude oil prices.

Recent changes in tax law, too, have increased the internal funds available to corporations for investment, reducing their need to go to debt and equity markets. The depreciation and other changes in the Economic Recovery Tax Act of 1981 (ERTA), modified in 1982, cut corporate taxes by about $9 billion in 1982, and are expected to reduce them by about $7 billion in 1983.

The conditions are thus in place for an expansion in investment activity, provided that the state of demand permits it and provided that interest rates do not rise again significantly. The June survey of investment anticipations by the Commerce Department suggests an increase of about 6 percent in plant and equipment spending between the fourth quarters of 1982 and 1983. This would be a somewhat slower rate of increase than in previous cyclical upturns, but the survey usually understates actual spending as reported in the National Income Accounts at the beginning of recoveries. With prices for capital goods expected to be stable, the anticipations survey would imply a similar percentage increase in real spending.

Nonresidential construction usually declines for about a year after the beginning of an upturn in economic activity. The lag is likely to be longer than usual this time, for two reasons:

- The extraordinary current level of real interest rates has a much heavier impact on long-lived construction investment than on shorter-lived investment. These high rates probably more than offset the more favorable treatment accorded to structures investment in ERTA.

- Business construction was supported during the recession by an office building boom. This boom has now ended, office vacancy rates are high, and office construction is likely to continue to fall off.

Equipment purchases, unlike business construction, generally turn up promptly with a recovery in economic activity. Spending on producers' durable equipment rose at a 9.4 percent annual rate in the first half of 1983, one of the strongest recoveries in investment in the postwar period.

Shipments and new orders for nondefense capital goods have increased a little and the order backlog has risen for the first time in two years.

Net Exports

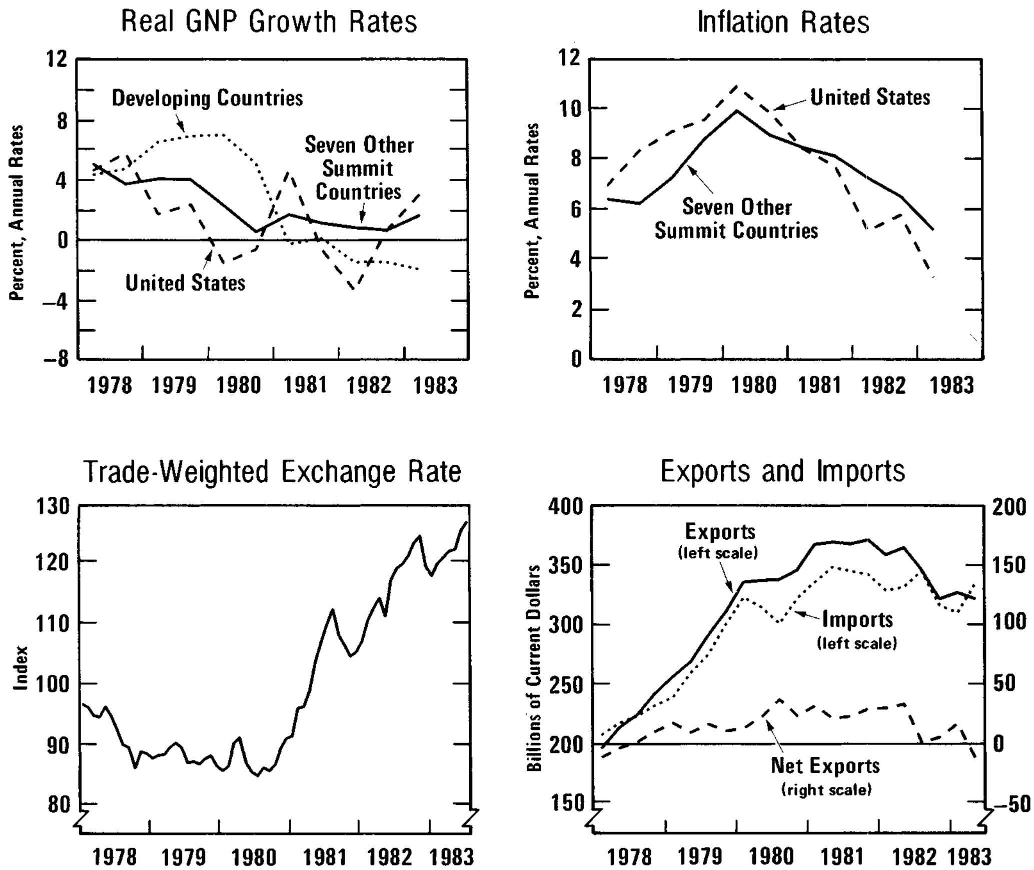
Net exports of goods and services in the second quarter showed a deficit of $12.5 billion at annual rates, the first deficit in this balance since 1978. A downward trend in the external accounts of the United States had been clear for some time. In terms of 1972 dollars, the net export balance declined from over $53 billion at an annual rate in mid-1980 to $23.0 billion in the fourth quarter of last year. Since then, it has dropped further to $10.2 billion for the second quarter of this year. The deterioration was particularly dramatic in the merchandise trade balance, now averaging deficits of more than $70 billion dollars at annual rates. The record trade deficits account for as much as a 1½ percent loss in real GNP over the last three years, and are expected to be a drag on the domestic economy this year as the recovery gathers steam.

Net exports usually improve during a recession, which tends to cut imports. But the severity of the recession abroad cut demand for U.S. exports, and the high dollar exchange rate kept export prices uncompetitively high and import prices abnormally low during the recession. Thus, while merchandise exports fell $46.7 billion from mid-1981 to the end of last year, merchandise imports dropped only $30.7 billion.

It is likely that recovery will bring further worsening of net exports. So far, only the U.S. economy has shown any real signs of strong recovery (see Figure 14). Not only are the main U.S. trading partners lagging behind, but many debt-burdened developing countries are still experiencing economic contraction. At present it appears likely that there will be no significant recovery for the main trading partners until late this year, and whatever recovery does occur will be less than normal. The Organization for Economic Cooperation and Development, in its annual forecast report, expects a modest 2.0 percent real growth rate for the largest U.S. trading partners in the second half of 1983, and a 2.4 percent growth rate for 1984—a full percentage point below average growth rates in the 1970s. Progress by developing countries in rescheduling their international debts has been made possible through stringent austerity measures coupled with sharp cutbacks in their imports. Since those countries account for about a third of U.S. exports, and the OECD countries account for most of the rest, the outlook for exports is poor. In the meantime, growing U.S. demand will further increase imports.

Improvement in the international trade sector of the economy will be slow. The continuing high value of the dollar means that imports remain

Figure 14.
Determinants of Net Exports



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Organization for Economic Cooperation and Development; Federal Reserve Board.

relatively more attractive to U.S. consumers while U.S. goods and services are relatively dear to foreigners. Moreover, U.S. firms have lost export markets that will take some time to recoup because of the time required for international contractual and marketing arrangements. Consequently, even if the dollar does depreciate to more appropriate levels, lags in the response of trade flows to exchange rate changes imply that any improvement is at least a year away.

THE MAKEUP OF THE TRADE DECLINE

The merchandise trade balance deteriorated dramatically during the course of the recession. Exports declined by $46.7 billion. Imports declined as well with about three quarters of the drop of $30.7 billion attributable to decreased imports of petroleum and products. Oil imports continued to decline through March, but have since risen sharply, contributing along with increased auto imports to a merchandise trade deficit of $71 billion at an annual rate in May and June.

	Before the Recession 1981:2	End of Recession 1982:4	Difference
Merchandise Exports (current dollars)			
Food, Feeds, Beverages	37.9	27.3	-10.6
Industrial Supplies, Materials	65.6	57.7	-7.9
Capital Goods (except automotive)	83.0	66.5	-16.5
Automotive	19.8	13.5	-6.3
Consumer Goods (nonfood)	16.1	13.8	-2.3
Other	17.7	14.6	-3.1
Total	240.1	193.4	-46.7
Merchandise Imports (current dollars)			
Foods, Feeds, Beverages	18.2	17.7	-0.5
Industrial Supplies, Materials (nonpetroleum)	54.4	45.3	-9.1
Petroleum and products	83.2	60.5	-22.7
Capital Goods (except automotive)	35.4	34.4	-1.0
Automotive	30.9	31.3	0.4
Consumer Goods (nonfood)	37.4	39.0	1.6
Other	10.0	10.6	0.6
Total	269.5	238.8	-30.7
Merchandise Balance	-29.4	-45.4	-16.0
Net Exports of Goods and Services			
In current dollars	21.1	5.6	-15.5
In 1972 dollars	44.1	23.0	-21.1

CHAPTER III. MONETARY AND FISCAL POLICY

The current recovery owes much to the significant easing of monetary policy that occurred last summer and to the expansive fiscal policy. Nevertheless, real interest rates—those adjusted for inflation—remain stubbornly high, and now threaten to move still higher, especially if measures to reduce deficits are not enacted. As a result, there is risk that high interest rates will stall the recovery in housing and weaken other sectors after only a few quarters. Equally serious is the longer-term danger that persistently high real interest rates will depress the level of investment below the pattern that is typical in recoveries, holding down growth in productivity and per capita income.

It is not hard to find reasons for the persistence of high rates in the recent and prospective behavior of monetary and fiscal policies. High and rising federal deficits, strong money demand, and indecision on the part of policymakers about what to do in these conditions may all contribute to holding up rates. This chapter describes recent developments in financial and budget conditions and the problems for policy.

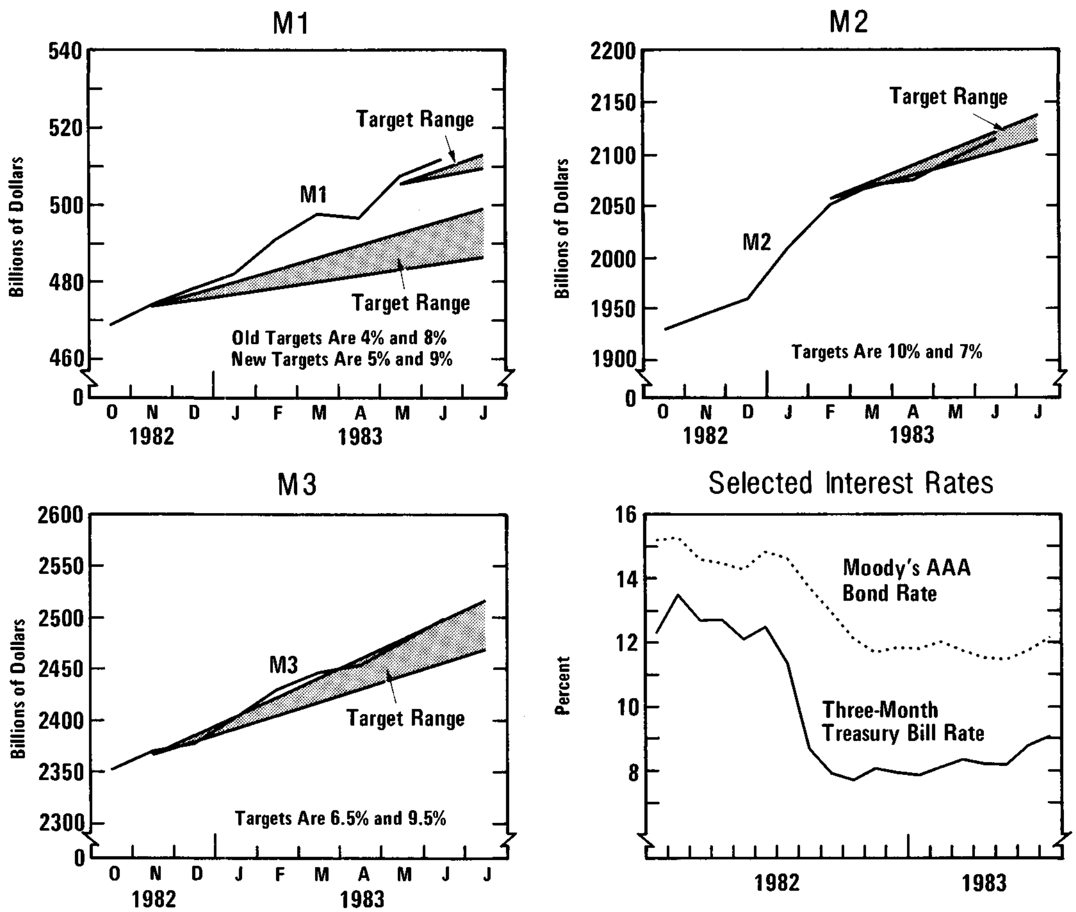
MONETARY POLICY AND FINANCIAL CONDITIONS

Events in the financial sector have complicated the analyst's work. Strong growth in the monetary aggregates has raised fears of future inflation, and evoked calls for monetary restraint. On the other hand, real interest rates have remained high despite the rapid growth in the money supply.

The combination of rapid money expansion and high real interest rates is unusual. It may reflect several factors: the possibility that federal deficits will crowd out private borrowing; the fact that the recovery is strong; the effects of volatility in financial markets; and/or a tendency of the public to hold more of its assets in the form of money. To the extent that the latter factor is important—that there has been a permanent increase in the demand for money—the fears of inflation may prove unfounded, since the additional money will not contribute to a demand for goods. The remainder of this section will review the data on the monetary aggregates and assess the role of the Federal Reserve's current monetary policy.

Figure 15.

Monetary Targets and Selected Interest Rates



SOURCE: Federal Reserve Board.

NOTE: M1, M2, and M3 are alternative measures of money supply. M1 consists of items, such as currency and demand deposits, considered likely to be used for financing current purchases. M2 and M3 include items more likely to be held as financial assets, such as savings deposits. Specifically, M1 consists of currency in circulation, travelers' checks, checking accounts, and other checkable deposits at depository institutions. M2 consists of M1 plus savings and small time deposits at depository institutions, money market mutual fund shares, and some overnight repurchase agreements and Eurodollar deposits. M3 is M2 plus large time deposits, term repurchase agreements, and institution-only money market mutual fund balances.

Monetary Targets and Velocity

In February, the Federal Reserve Board announced new monetary targets that it believed would promote a moderate and sustainable recovery without reigniting inflation (see Figure 15). Although the new target ranges are somewhat higher than last year's, the Federal Reserve stated that recent changes in the financial system--including but not limited to the advent of new deposit instruments—meant that the new targets actually called for somewhat slower "effective" growth in the aggregates. (Since inflation is expected to be lower this year than last, real growth in the money supply may nevertheless be the same or higher.) Moreover, the central bank announced that it would emphasize the behavior of the broader aggregates M2 and M3, and that the base for the M2 target would be the February/March average rather than that of the fourth quarter of the previous year as is customary. 1/ The deemphasis of Ml and the rebasing of the M2 growth targets were seen as evidence of a more flexible approach, one that relies more heavily on judgment in setting target ranges and in interpreting movements in the aggregates relative to these ranges.

The behavior of the monetary aggregates in the first six months of 1983 confirms this increased flexibility. Ml continued to expand very rapidly—14.6 percent at an annual rate from December through June—and at the end of the period stood well above the target range established in February. M2 and M3 also exhibited robust growth and are currently near their respective upper target limits. The rapid money growth, especially in Ml, prompted fears in the financial markets that the Federal Reserve would be forced to tighten up. In July, however, it stated in its midyear policy report that, although it had been somewhat less accommodative in recent weeks, the markets should not expect the degree of tightening necessary to

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1/ The rebasing of M2 was a direct attempt to offset the anticipated effect of the new deposit instruments authorized in December and January. A Federal Reserve study indicated that the new instruments had a marked effect on M2, but a much smaller impact on Ml and M3. This occurred because money market deposit accounts (MMDAs), authorized last December and included in M2, attracted a significant amount of funds from sources outside of M2—preliminary estimates place this figure as high as $70 billion. By contrast, the new instruments have had only a minimal effect on Ml, because inflows to super-NOW accounts, which are included in Ml, have come primarily from other Ml components or have been offset by outflows from Ml into new instruments, such as MMDAs, that are not in Ml. M3 is also thought to be only minimally affected because most of the funds flowing into either of the new deposit categories came from, or were offset by, funds already in M3.